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No. 86-1982

In the Supreme Court of the United States

OCTOBER TERM, 1987

CLARENCE K. HOWE, ET UX., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether certain lump-sum amounts paid by petitioner in the form of cash and a nonrecourse promissory note constituted "advanced minimum royalties" within the meaning of Treas. Reg. § 1.612-3(b)(3).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-11a) is reported at 814 F.2d 98. The memorandum of the Tax Court (Pet. App. 12a-19a) is reported at 50 T.C.M. (CCH) 689.

JURISDICTION

The judgment of the court of appeals was entered on March 17, 1987. The petition for a writ of certiorari was filed on June 11, 1987. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Pursuant to a tax-shelter scheme, petitioner Clarence Howe[1] and other individuals entered into a

[1] Petitioner Margaret Howe is a party to these proceedings solely by virtue of having filed a joint federal income tax return with her husband, Clarence, for the tax year at issue. Accordingly, references to "petitioner" pertain to Clarence Howe.

coal sublease arrangement with Fairchild Coal Corporation (Fairchild) in December 1977. The sublease provided each investor with various rights to mine coal reserves for a period of 11½ years. The investors agreed to pay Fairchild a "minimum annual royalty" of $177,650 for each lease year. The agreement further provided that the "minimum annual royalties" for the first nine lease years, totalling $1,598,850, were to be paid in a lump sum simultaneously with the execution of the sublease. Of that amount, $306,850 was to be paid in cash and $1,292,000 was to be represented by the execution and delivery to Fairchild of a nonrecourse promissory note. The sublease labelled this lump-sum payment an "advanced minimum royalty." The "minimum annual royalty" for the tenth and eleventh years was to be paid on December 31 of those years. Pet. App. 3a.

The sublease agreement also required the investors to pay a "tonnage royalty" of $5.50 per ton for the first 32,300 tons of coal mined, removed, and sold from the property. It allowed the investors to offset the "advanced minimum royalty" against the "tonnage royalty" otherwise due. Pet. App. 3a. According to the terms of the sublease, the obligation to pay royalties was without recourse. In the event that petitioner and his fellow investors defaulted on any of their obligations, Fairchild's only remedy was to proceed against the collateral described in the sublease. In essence, the collateral consisted of the investors' mineral interest together with any facilities or equipment used in connection with the mining operation. *Id.* at 4a.

Upon executing the sublease, petitioner paid his pro rata share of the "advanced minimum royalty" by delivering to Fairchild $11,000 in cash and his nonrecourse note in the amount of $34,000. As contemplated in the sublease, the note provided for the payment of nine annual installments of principal and the payment of interest on the unpaid balance at an annual rate of six percent (see Pet. App. 4a).

Consistent with the sublease (see *id.* at 11a), the note further provided that Fairchild could not declare the note due and payable until a payment was 12 months overdue and the borrower had failed to remedy the default within three months after written notice thereof (see *id.* at 6a; C.A. App. A85). Like the royalty obligations, the note was secured solely by petitioner's interest in the sublease and any property used in the development thereof; petitioner was not personally liable for any amounts payable under the note (Pet. App. 4a). The record does not indicate that petitioner ever acquired any facilities or equipment for developing his mineral interest. During 1977 and 1978, no coal was mined by or on behalf of petitioner (Pet. App. 16a).

2. On his 1977 federal income tax return, petitioner claimed a loss of $42,620 from the mining business. In computing this loss, petitioner reported that he had no income from the mining business, and he claimed deductions of $42,075 for royalties and $545 for "associated expenses" (Pet. App. 2a). The Commissioner disallowed the loss deduction in its entirety.

Petitioner sought redetermination of the resulting deficiencies in the Tax Court, which granted the Commissioner's motion for partial summary judgment and sustained his position on the royalty issue.[2] The court held that petitioner's obligation to pay minimum royalties was so contingent in nature as to be illusory. Specifically, the court held (Pet. App. 17a-19a) that the arrangement did not satisfy the definition of a "minimum royalty provision" contained in Treas. Reg. § 1.612-3(b)(3). That regulation generally permits the current deduction of royalties only where they relate to coal that is actually mined in a given year. An exception is provided for

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[2] Issues concerning the deductibility of the $545 in "associated expenses" were settled by the parties and were not addressed by the Tax Court.

royalties paid or accrued pursuant to a "minimum royalty provision," which essentially is defined as a provision requiring annual and uniform payments of royalties regardless of production. The court noted that, by virtue of the nonrecourse nature of the sublease agreement and the note, petitioner's obligation to pay minimum royalties was contingent upon the production of coal. Accordingly, the court concluded, petitioner was not required to make the annual and uniform minimum royalty payments envisioned by the regulation. *Ibid.*

3. The court of appeals unanimously affirmed (Pet. App. 1a-11a). Although it departed in some respects from the Tax Court's analysis, the court of appeals agreed with the Tax Court's holding that the sublease arrangement did not create a genuine "minimum royalty provision." Relying on its prior opinion in *Brown* v. *Commissioner*, 799 F.2d 27, 31 (2d Cir. 1986), the court of appeals concluded that, because the sublease and the note permitted petitioner to withhold payments under the note without penalty for over a year, he was not required to make the "annual and uniform" royalty payments envisioned by the regulation (Pet. App. 6a-7a). The court also rejected petitioner's argument that the regulation, which requires the actual payment of royalties as a precondition to recognition of a true minimum-royalty arrangement, could not validly be applied to petitioner, an accrual-basis taxpayer (*id.* at 7a-9a). The court explained (*id.* at 8a (emphasis in original)):

> The actual payment requirement of the regulation is designed to create an incentive to undertake the mining of the coal by requiring yearly payments *without regard* to the amount of coal actually mined. * * * The purpose is to create immediate liability in order to encourage coal production. * * * Absent this requirement of actual payment on an annual basis, the use of non-recourse notes would enable individuals to

realize inflated deductions without actually having to make the underlying outlays.

Because the focus of the regulation is on "the nature of a taxpayer's obligation to make the payments for which he claims deductions," the court stated, petitioner's status as an accrual-basis taxpayer was completely irrelevant (*ibid.*).

ARGUMENT

Petitioner contends (Pet. 6-13) that his delivery of the nonrecourse note could qualify as an "advanced minimum royalty" under the applicable Treasury Regulation, and that the Tax Court should have held a trial to determine whether petitioner had a sufficient "economic incentive" to make the payments on the note. The court of appeals correctly rejected this contention, and its decision does not conflict with any decision of this Court or of another court of appeals. Accordingly, there is no basis for further review.

1. Mineral royalties traditionally have been described as akin to rent, and they generally are deductible as a trade-or-business expense under Section 162(a)(3) of the Internal Revenue Code.[3] See, *e.g.*, *Commissioner* v. *Jamison Coal & Coke Co.*, 67 F.2d 342, 344 (3d Cir. 1933); *Burnet* v. *Hutchinson Coal Co.*, 64 F.2d 275, 278 (4th Cir.), cert. denied, 290 U.S. 652 (1933). "Advanced minimum royalties" are royalties that are payable annually in a minimum amount if less than a specified amount of coal is mined in a given year, with the result that the regular tonnage royalty would be less than the minimum. When paid, such royalties are treated as a credit against future "earned royalties," *i.e.*, royalties paid upon actual production. See, *e.g.*, *Davis* v. *Commissioner*, 746 F.2d

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

357, 359 (6th Cir. 1984). As noted by the Second Circuit below (see Pet. App. 8a), an advanced minimum royalty provision is designed to approximate the amount of royalties that would be generated at a certain level of production and to provide a financial inducement for the lessee to attain that level of production as quickly as possible. See *Ward* v. *Commissioner*, 784 F.2d 1424, 1429 n.7 (9th Cir. 1986); *Wing* v. *Commissioner*, 81 T.C. 17, 38 n.30 (1983).

Under Treas. Reg. § 1.612-3(b)(3), advanced royalties generally are deductible only in the year in which the mineral product to which they relate is sold (or produced, if it is sold before it is produced). The regulation contains an exception, however, for advanced royalties paid as a result of a "minimum royalty provision." These may be treated "as deductions from gross income for the year in which the advanced royalties are paid or accrued." The regulation goes on to limit this exception by providing that an arrangement gives rise to a legitimate "minimum royalty" only if it "requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years." Thus, a current deduction for advanced minimum royalties is available only where annual and uniform payment of the royalties is required. See P. Maxfield & J. Houghton, *Taxation of Mining Operations* § 3.03[2] (1987); *Redhouse* v. *Commissioner*, 728 F.2d 1249, 1252 (9th Cir.), cert. denied, 469 U.S. 1034 (1984).[4]

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[4] The validity of this regulation has been upheld on several occasions and is not challenged here. See, *e.g.*, *Wendland* v. *Commissioner*, 739 F.2d 580 (11th Cir. 1984); *Redhouse* v. *Commissioner*, *supra*; *Long* v. *United States*, 10 Cl. Ct. 46 (1986), aff'd in relevant part and vacated in part on other grounds, No. 86-1316 (Fed. Cir. Apr. 9, 1987), modified (June 24, 1987).

Thus, the court of appeals was clearly correct in ruling that petitioner was not entitled to a current deduction for his so-called "advanced royalty" payment since that amount was not paid or accrued "as the result of a minimum royalty provision" within the meaning of Treas. Reg. § 1.612-3(b)(3). First, the sublease itself plainly did not require the annual and uniform payments envisioned by the regulation; the sublease required only a lump-sum payment at the outset and no other payments until the tenth lease year. The promissory note similarly failed to satisfy this precondition. By its terms, it prohibited Fairchild from enforcing payment thereof until petitioner had been in default for one year and then had been given three months to cure his default. As the court of appeals pointed out (Pet. App. 7a), the effect of these limitations on enforcement was to allow petitioner to postpone payment with impunity for up to 15 months, thereby negating any annual payment requirement apparently contained on the face of the note. See also *Maddrix* v. *Commissioner*, 780 F.2d 946, 951 (11th Cir. 1986).

Contrary to petitioner's assertion (Pet. 6-9), the court of appeals manifestly did not propound a general rule that nonrecourse notes should always be disregarded for tax purposes. Indeed, the court of appeals specifically noted that it had earlier rejected the contention "that the nonrecourse nature of a taxpayer's obligation * * * automatically prevent[s] deductibility under Treas. Reg. § 1.612-3(b)(3)" (Pet. App. 5a-6a). Rather, the court simply held that the annual-payment requirement of the regulation was not satisfied here because the terms of this particular nonrecourse note permitted petitioner, without legal detriment, to defer payment thereon for periods in excess of one year. The court of appeals' holding to that effect is clearly correct.[5]

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[5] Given the obvious limitations on enforcement of the nonrecourse note, there is no merit to petitioner's suggestion (Pet. 9-10) that the

2. Petitioner's contention (Pet. 7-9) that the decision below is inconsistent with this Court's decisions in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), and *Commissioner* v. *Tufts*, 461 U.S. 300 (1983), is similarly without merit. In *Crane*, this Court held that a taxpayer must include in the amount realized upon the sale of an asset the unpaid balance of a nonrecourse mortgage whose balance was less than the fair market value of the property. 331 U.S. at 13-14.[6] This Court in *Tufts* extended the *Crane* holding to cover situations where the unpaid balance of the nonrecourse mortgage exceeds the fair market value of the property. 461 U.S. at 307.

This Court's holdings in *Crane* and *Tufts* were based on the particular situations there involved, and the Court relied upon "the Commissioner's decision to treat a nonrecourse mortgage *in this context* as a true loan." *Commissioner* v. *Tufts*, 461 U.S. at 307 (emphasis added).[7] Neither

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court of appeals should have remanded the case for a factual investigation into the value of the property securing the note, an investigation that allegedly would show that petitioner had an "economic incentive" to make annual payments. Even if one assumes arguendo that the value of the secured property was sufficient to assure that petitioner would *ultimately* repay the loan in order to retain the collateral, that fact would provide no assurance that petitioner would actually make payments on the annual basis required by the regulation. The collateral could be preserved by making payment 15 months after the due date. See *Capek* v. *Commissioner*, 86 T.C. 14, 47 (1986) ("Even assuming that the petitioners would eventually pay the notes, payment after the close of the taxable year does not satisfy the requirement of the regulation that the royalties 'be paid at least annually' over the term of the lease."); *Wing* v. *Commissioner*, 81 T.C. 17, 41 (1983).

[6] See I.R.C. §§ 1001 and 1011 (gain on sale of property is equal to the excess of the amount realized over the taxpayer's adjusted basis in the property).

[7] The approach of the Commissioner upheld in *Crane* and *Tufts* was necessary to maintain consistent treatment by both including the principal of a nonrecourse mortgage in the taxpayer's depreciable

Tufts nor *Crane* purported to establish a universal rule that treats nonrecourse debt as the equivalent of recourse debt for all tax purposes (see *Saviano* v. *Commissioner*, 765 F.2d 643, 649-650 (7th Cir. 1985)), and the decision below is fully consistent with those precedents. Moreover, in *Tufts* and *Crane* the Court paid deference to the Commissioner's treatment of the nonrecourse mortgage as appropriate in that context. See 461 U.S. at 307, 310 & n.11. Those holdings do not support petitioner's effort here to overturn the Commissioner's regulatory treatment of advanced minimum royalties, which is entitled to considerable deference (see, *e.g.*, *Fulman* v. *United States*, 434 U.S. 528, 533 (1978)).

3. Petitioner also contends (Pet. 11-12) that the "actual payment" rule invoked by the court of appeals does not apply to an accrual-basis taxpayer; petitioner argues that the regulation's earlier references to royalties "paid *or accrued*" should be imported into its definition of "minimum royalty provision." But the plain language of that definition unambiguously provides that "a minimum royalty provision requires that a substantially uniform amount of royalties *be paid* at least annually," not merely that they be accrued. Treas. Reg. § 1.612-3(b)(3) (emphasis added). As the court of appeals explained (Pet. App. 8a), the "actual payment" requirement of the regulation is reasonable because it "is designed to create an incentive to undertake the mining of the coal by requiring yearly payments" and to "create immediate liability in order to encourage coal production." See also *Ward* v. *Commissioner*, 784 F.2d at 1429 & n.7. Acceptance of petitioner's argument would permit accrual-basis tax-

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basis in the property and including the unpaid balance of the mortgage in the amount realized on the sale of the property. See *Tufts*, 461 U.S. at 309, 313; *Crane*, 331 U.S. at 13-14. See generally Halliday & Manno, *Death of a Footnote: A Current View of* Crane *and the Road to* Tufts, 36 S.C.L. Rev. 403, 429 (1985).

payers, by the use of nonrecourse notes, "to realize inflated deductions without actually having to make the underlying outlays" (Pet. App. 8a). Such a result would eviscerate the regulation.

Contrary to petitioner's contention (Pet. 12), this requirement of actual payment does not render superfluous the prior portion of the regulation that provides that a taxpayer may deduct amounts "paid or accrued" as "advanced royalties." This case involves a subset of the universe of "advanced royalties"—viz., advanced royalties paid in connection with a "minimum royalty provision"—and the question is whether the arrangement that petitioner entered into was a "minimum royalty provision" within the meaning of the regulation. The regulation clearly provides that a uniform stream of royalties must "be paid at least annually" in order for there to be such a provision, and hence it recognizes that an arrangement like the one here does not truly create a fixed obligation to make an annual minimum royalty payment. Thus, as the court of appeals explained (Pet. App. 9a), to the extent "the regulation interferes with [petitioner's] ability to accrue [his] liabilities, this interference results from the illusory nature of [his] obligations under the non-recourse note."[8]

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[8] The "actual payment" requirement merely reflects the fact that in the real world, as opposed to the economic fantasyland of tax shelters, a lease generally requires the payment, rather than the mere accrual, of rent. This does not preclude an accrual-basis taxpayer from deducting the rent, prior to the payment thereof, at the time the liability for rent becomes fixed; but it does preclude him from deducting purely hypothetical expenditures. It should also be noted that even if one assumes arguendo that the sublease here contained a valid minimum royalty provision, it is far from clear that petitioner's delivery of a nonrecourse note would constitute "payment" of the royalties within the meaning of the regulation. See *Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569, 577-578 (1977).

4. Finally, there is no merit to petitioner's suggestion (Pet. 12) that the decision below conflicts with the decisions of other courts of appeals. Although other courts have taken somewhat different theoretical approaches to the issue presented here, there is no disagreement about the correct result. Every court that has considered whether provisions similar to those contained in petitioner's sublease and note constitute "minimum royalty provisions" within the meaning of Treas. Reg. § 1.612-3(b)(3) has held that they do not. See *Maddrix* v. *Commissioner, supra; Ward* v. *Commissioner, supra;* see also Long v. *United States, supra.* Accordingly, the decision below does not present a conflict among the circuits that requires resolution by this Court.[9]

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[9] In addition, we note that the prospective importance of the issue presented here is considerably diminished, if not entirely eliminated, by Section 465(a) of the Code, which, for taxable years beginning in 1979, precludes a taxpayer from taking royalty deductions in excess of the amount he or she has at risk in the investment. As petitioner apparently recognizes (see Pet. 12), Section 465(a) strikes at the heart of tax shelters such as the one involved here by limiting a taxpayer's royalty deductions to the amount of cash invested in the shelter. See I.R.C. § 465(b); *Capek* v. *Commissioner*, 86 T.C. at 47-48. Section 465 thus precludes an investor in a coal-mining tax shelter from using a nonrecourse note to generate deductions that exceed his cash investment. See generally *Commissioner* v. *Tufts*, 461 U.S. at 309 n.7.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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